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In the Supreme Court of the United States

OCTOBER TERM, 1983

FEDERAL ENERGY REGULATORY COMMISSION,
PETITIONER

v.

TENNECO OIL COMPANY, ET AL.

ON PETITION FOR A WRIT OF CERTIORARI TO THE
UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

REPLY MEMORANDUM FOR THE PETITIONER

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In our petition, we contended that the decision of the court of appeals—holding that the lease sale agreements at issue are not subject to Commission regulation under the Natural Gas Act, 15 U.S.C. 717 *et seq.*—constitutes a clear departure from the fundamental teachings of this Court in *Phillips Petroleum Co. v. Wisconsin*, 347 U.S. 672 (1954), and *United Gas Improvement Co. v. Continental Oil Co.*, 381 U.S. 392 (1965) (*Rayne Field*). We also argued that, unless the decision below is reversed, respondents would

reap an enormous windfall—at the expense of the pipelines and/or their customers—for many years to come.¹ The points raised by respondents warrant only a few brief comments.

1. It is common ground that, in determining whether the Commission has jurisdiction over lease sale agreements, the dispositive question is whether what was sold was gas reserves or merely the right to explore for gas. Respondents contend (PLA Resp. Br. in Opp. 14; Tenneco Oil Br. in Opp. 12-13) that under *Rayne Field*, “substantiality of development” is an absolute prerequisite to a finding of Commission jurisdiction. We disagree. The central teaching of *Rayne Field*, which respondents ignore, is that the jurisdictional question turns on the overall economic and commercial realities of the transaction, not on application of a rigid, mechanistic formula.

Viewed in these terms, the lease sale transactions at issue must be regarded as subject to the Commission’s jurisdiction. As we demonstrated in our petition (at 19-20), the economic realities support the Commission’s conclusion that the respondent gas producers were not leasing the right to explore land for gas but were selling gas in place. The record convincingly shows that the producers sold proven gas reserves² for resale in interstate commerce pursuant

¹ For example, the GLA respondents are presently receiving “royalties” of about \$3.50 per MMBtu—a rate that exceeds by more than 400% the current NGPA price for “old” or “flowing” gas. As we explain below (see note 5, *infra*), this rate could almost triple by next year.

² Where lease sale acreage is proven, the economic reality is that gas, not exploration rights, is being sold. The court of appeals in this case acknowledged (Pet. App. 15a) that “the record reveals the reserves in the [San Juan] Basin may well

to contracts that were similar in substance to conventional wellhead sales contracts.³ Moreover, these reserves were sufficiently developed to permit the two pipeline companies to obtain the regulatory approval and financial commitments necessary to construct major segments of their pipelines.⁴ In short, "[t]he

have been 'proven' at least within reasonable estimates." As the ALJ observed, the particular geological structure of the Basin "tended to assure that gas would be encountered at virtually any location" (Pet. App. 53a (footnote omitted)). The ALJ cited the testimony of a witness for Northwest, who stated that the pipeline had drilled several hundred wells in the Basin and had never encountered a dry hole (*id.* at 53a n.47).

³ The contracts provided for: (1) a specified sum per Mcf subject to periodic escalation; (2) rate redetermination at the end of a fixed term; and (3) favored nations clauses and take-or-pay clauses. In addition, the contracts imposed strict drilling requirements on the pipelines.

⁴ To be sure, the San Juan Basin fields here involved were not as developed as was Rayne Field. As we explained in our petition, however, under the practical approach applied in *Continental Oil Co. v. FPC*, 370 F.2d 57 (5th Cir. 1966), cert. denied, 388 U.S. 910 (1967) (*Ship Shoal*), the fields here certainly "reached the stage of proof and development necessary to satisfy the *Rayne* criteria" (370 F.2d at 64).

In an effort to distinguish this case from *Ship Shoal*, respondents argue (Union Oil Br. in Opp. 19-21; PLA Resp. Br. in Opp. 19-21) that the field in *Ship Shoal* was substantially developed, whereas the fields involved in the instant lease sale transactions were not. Respondents' argument is wide of the mark. At the time of the transfer in *Ship Shoal*, only two of the estimated 36 to 42 completions needed to develop the field for gas production were in place. Of the twelve wells that had been drilled, only one was a gas well; the others were oil wells or dry holes. The subsequent drilling of five potential gas wells to which respondents refer (PLA Resp. Br. in Opp. 20) was done by the pipeline purchasers (following closing), not by the producers. See *Ten-*

crucial fact here, as in *Rayne*, is that the assignment of the leases accomplished the transfer of large amounts of substantially proven * * * gas reserves to an interstate pipeline for eventual resale in interstate commerce * * *." *Ship Shoal*, 370 F.2d at 67.

By contrast, respondents' analysis defies economic reality. As we pointed out in our petition (at 7 n.9, 16), the special overriding royalties involved here, which are payable on the net interest assigned (as in *Rayne Field* and *Ship Shoal*), are about six to seven times greater than typical land owner royalties (70%-80% v. 12½%). Respondents do not explain why this "royalty" level is so high if, under their theory of the case, the transactions merely involved the right to explore otherwise worthless land for gas. Moreover, respondents' theory rests on the wholly invalid assumption that the Commission and the financial community would approve major pipeline construction solely on the basis of exploration rights. The simple economic reality is that these transactions involved the sale of natural gas reserves in place.

2. Respondents contend (PLA Resp. Br. in Opp. 16-19; Union Oil Br. in Opp. 10-11) that the decision below can have no prospective impact on natural gas consumers because, under this Court's decision in *Public Service Commission v. Mid-Louisiana Gas Co.*, No. 81-1889 (June 28, 1983), the rates charged by

nessee Gas Transmission Co., 30 F.P.C. 759, 798, 803 (1963). Respondents' submissions to this Court overstating the level of development in *Ship Shoal* stand in sharp contrast to the producers' petition for a writ of certiorari in *Ship Shoal*, in which the producers stated that "only one gas well had been completed, no gas had been produced, and at the time of transfer 34 to 40 completions were anticipated for development" (*Continental Oil Co. v. FPC*, petition for cert., No. 1323, at 6 (Oct. Term, 1966)).

El Paso and other pipelines for first sales of pipeline-produced gas may not exceed the applicable ceiling rates in Title I of the Natural Gas Policy Act of 1978, 15 U.S.C. 3301 *et seq.* (NGPA). On the contrary, we submit that the future ramifications of this one case alone are themselves sufficiently substantial to warrant certiorari.

Respondents do not dispute the assertion in our petition (at 22) that the lease sale acreage involved in this case presently contains estimated reserves of approximately three trillion cubic feet of gas. In addition, the GLA respondents cannot dispute that, at present, they are receiving "royalty" payments of more than \$3.50 per MMBtu for "old" natural gas, the current NGPA ceiling price for which is well under \$1.00 per MMBtu. Nor do respondents dispute that this approximate "400% monetary gap" will widen as the remaining reserves are utilized in future years.⁵ Rather, respondents assert (Union Oil Br. in Opp. 14-15; Tenneco Oil Br. in Opp. 24-26) that the impact of the "400% monetary gap" will fall on the pipelines, not the consumers—a consequence that, respondents suggest, does not justify review by this Court.

To be sure, as we acknowledged in our petition (at 21) and as respondents emphasize (Union Oil Br. in Opp. 10-11; PLA Resp. Br. in Opp. 18-19;

⁵ The 400% differential between the "royalty" being paid respondents and the NGPA ceiling price for the gas may be dwarfed by future differentials. In June 1985, following the scheduled deregulation of new gas under the NGPA (see 15 U.S.C. 3331(a)(1)), El Paso will be required to pay royalties to respondents based on the average of the three highest prices the pipeline pays for gas. At that point, the 400% differential could almost triple.

Tenneco Oil Br. in Opp. 9-10), the decision whether to shift financial responsibility from the pipelines to the ultimate consumers through special rate relief is a matter within the ultimate discretion of the Commission. See 15 U.S.C. 3314(b)(2); *FERC v. Pennzoil Producing Co.*, 439 U.S. 508 (1979). But respondents miss the point when they assert simplistically that the Court should not be concerned about the adverse future impact of the decision below because the financial fallout may fall on the pipelines rather than on the ultimate consumers. Respondents' argument is based on an unduly restrictive view of the scope of the Commission's responsibility to protect the public interest under both the Natural Gas Act and the NGPA. The "public interest" over which the Commission stands watch encompasses all segments of the natural gas industry—consumers, distributors, state commissions, pipelines and producers. See, e.g., *NAACP v. FPC*, 425 U.S. 662, 669-670 (1976). As the court pointed out in *Consumer Federation of America v. FPC*, 515 F.2d 347, 357-358 (D.C. Cir.), cert. denied, 423 U.S. 906 (1975), this Court has consistently rejected the notion that the Commission need not concern itself with the level of producer rates "on the ground that the pressures built up by producer rate increases could somehow be contained at the pipeline level by invoking a regulatory agency's authority to disallow 'excessive' costs." It is clear that either the pipelines or the ultimate consumers will suffer severe financial dislocation absent reversal of the court of appeals' erroneous decision.⁶

⁶ Respondents' attempt to cast the impact of the court of appeals' decision on future gas prices as essentially a private dispute between themselves and El Paso (*E.g.*, Union

In our petition (at 20-21), we pointed out that if the Commission is held to have jurisdiction, gas consumers would be able to assert claims for more than \$1 billion in refunds for the special overriding royalties paid to respondents in the period between 1974 and 1983.⁷ Respondents, not surprisingly, dispute

Oil Br. in Opp. 14-15) is misleading. In order to mitigate the enormous future impact of the decision below on the pipelines, both El Paso and Northwest have entered into settlements with some of the respondents. The settlement between Northwest and Phillips has already been approved by the Commission. In approving that settlement, the Commission noted that "Phillips is offering to accept rates under PLA-5 that could save Northwest, and eventually its consumers, as much as \$50 million a year." *El Paso Natural Gas Co.*, 25 F.E.R.C. ¶ 61,292, at 61,674 (1983) (emphasis added). The settlements between El Paso and Union (*Union Oil Co. of California*, Docket No. CI84-141-000 (filed Dec. 13, 1983)) and between El Paso and both Tenneco and Conoco (*El Paso Natural Gas Co.*, Docket No. CP74-314, *et al.* (filed May 18, 1984)), which have not yet been approved by the Commission, raise numerous complex issues relating to future gas cost and gas supply.

With regard to the impact of the decision below on the pipelines, respondents' argument (Union Oil Br. in Opp. 14-15; Tenneco Oil Br. in Opp. 24-25) that application of *Mid-Louisiana* to the El Paso system will be beneficial to the pipeline overall is wholly irrelevant. The fact that El Paso is entitled, under *Mid-Louisiana*, to additional revenues for its production from other properties has no bearing on whether the lease sale transactions at issue are subject to the Commission's jurisdiction and, if so, whether the rates paid by El Paso to respondents for the gas are unjust and unreasonable.

⁷ Respondents erroneously suggest (Tenneco Oil Br. in Opp. 22-23) that the Commission, in *El Paso Natural Gas Co.*, 57 F.P.C. 989 (1977), approved the level of these special overriding royalties as being just and reasonable. The Commis-

these claims (Union Oil Br. in Opp. 12-14; PLA Resp. Br. in Opp. 25-27).⁶ It is clear, however, that unless the court of appeals' decision is overturned, the affected natural gas consumers would be deprived of any opportunity to assert their refund claims.

For the foregoing reasons and those stated in our petition, it is respectfully submitted that the petition for a writ of certiorari should be granted.

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sion simply held that El Paso had acted prudently in entering into settlements after the Sun Oil arbitration award. Indeed, the Commission specifically stated that it was "not deciding whether the amounts received by the special overriding royalty interest owners, were they found to be jurisdictional, are just and reasonable" (57 F.P.C. at 1000).

* Even if there were merit to respondents' assertion that refunds should not be ordered for the period prior to September 25, 1980 (the date of the Commission's decision on jurisdiction), a point we do not concede, refunds of nearly half a billion dollars have been claimed for the period subsequent to that date.